

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-63777; File No. SR-Phlx-2010-157)

January 26, 2011

Self-Regulatory Organizations; NASDAQ OMX PHLX LLC; Order Approving a Proposed Rule Change, as Modified by Amendment Nos. 1 and 2, Relating to Complex Orders

I. Introduction

On November 29, 2010, NASDAQ OMX PHLX LLC (“Phlx” or the “Exchange”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the “Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to amend the rules governing the trading of Complex Orders on the Phlx’s electronic options trading platform, Phlx XL II, to, among other things: (i) permit Complex Orders with up to six components, including the underlying stock or Exchange Traded Fund Share (“ETF”); (ii) establish a Do Not Auction (“DNA”) designation for Complex Orders; (iii) add a definition of conforming ratio; (iv) provide priority rules for Complex Orders traded on Phlx XL II; and (v) provide for the communication of the stock or ETF component of a Complex Order by the Exchange to Nasdaq Options Services LLC (“NOS”), the Phlx’s affiliated broker-dealer, for execution. The Exchange filed Amendment No. 1 to the proposal on December 6, 2010.<sup>3</sup> The proposed rule change, as modified by Amendment No. 1, was published for comment in the Federal Register on December 15, 2010.<sup>4</sup> The Exchange filed Amendment No. 2 to the proposal

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 revises Phlx Rule 1080, Commentary .08(a)(i), to indicate that member organizations submitting Complex Orders with a stock/ETF component represent that such orders comply with the qualified contingent trade exemption from Rule 611(a) of Regulation NMS under the Exchange Act.

<sup>4</sup> See Securities Exchange Act Release No. 63509 (December 9, 2010), 75 FR 78320 (“Notice”).

on January 11, 2011.<sup>5</sup> The Commission received no comments regarding the proposal, as amended. This order approves the proposed rule change, as amended.

## II. Description of the Proposal

Currently, the Phlx's rules provide for the electronic trading of Complex Orders composed of two options components. As described in greater detail below and in the Notice,<sup>6</sup> the Phlx proposes to amend Phlx Rule 1080, Commentary .08, to provide for the electronic trading of Complex Orders composed of up to six components, which may include the underlying stock or ETF, and to make other changes to its rules governing the trading of Complex Orders on Phlx XL II.

### A. Definitions

The proposal amends Phlx Rule 1080, Commentary .08(a)(i) to define a Complex Order, for purposes of that rule, as (i) an order involving the simultaneous purchase and/or sale of two or more different options series in the same underlying security, priced as a net debit or credit based on the relative prices of the individual components, for the same account, for the purpose of executing a particular investment strategy; or (ii) a stock-option order. A stock-option order is composed of an order to buy or sell a stated number of units of an underlying security (stock or

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<sup>5</sup> Amendment No. 2 revises Phlx Rule 1080(m)(iii)(A) to include text that was inadvertently omitted from Exhibit 5 of the Form 19b-4 submission. Specifically, the revised text indicates that, in addition to its current routing function, the Routing Facility (as defined below) will execute and report the underlying security component of a Complex Order otherwise than on the Phlx, pursuant to Phlx Rule 1080.08(h). Phlx states that this change is a clarifying and technical correction to conform the text of Rule 1080(m)(iii)(A) to: (i) the discussion in the Form 19b-4 submission regarding the proposed additional functions of NOS; and (ii) proposed Rule 1080.08(h). Because Amendment No. 2 is technical in nature, it is not subject to notice and comment.

<sup>6</sup> See Notice.

ETF) coupled with the purchase or sale of options contract(s).<sup>7</sup> A Complex Order could be composed of up to six options series or, in the case of a stock-option order, five options series and the underlying stock or ETF.<sup>8</sup>

Stock-option orders may only be executed against other stock-option orders and cannot be executed against orders for the individual components.<sup>9</sup> A member may only submit a Complex Order with a stock or ETF component if the order complies with the qualified contingent trade exemption (“QCT Exemption”)<sup>10</sup> from Rule 611(a) of Regulation NMS under the Act,<sup>11</sup> and a member submitting a Complex Order with a stock or ETF component represents that its order complies with the QCT Exemption.<sup>12</sup>

The proposal also adds a definition of conforming ratio for Complex Orders composed solely of options and for Complex Orders that include the underlying stock or ETF.<sup>13</sup> For Complex Orders composed solely of options, a conforming ratio is where the ratio between the sizes of the options components of a Complex Order is equal to or greater than one-to-three (.333) and less than or equal to three-to-one (3.00). For Complex Orders that include the underlying stock or ETF, a conforming ratio is where the ratio between any options component and the underlying security component is less than or equal to eight contracts to 100 shares of the

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<sup>7</sup> See Phlx Rule 1080, Commentary .08(a)(i). In addition, the underlying security must be the deliverable for the options component of a stock-option order and must represent exactly 100 shares per option for regular way delivery. Id.

<sup>8</sup> See Phlx Rule 1080, Commentary .08(a)(i).

<sup>9</sup> Id.

<sup>10</sup> See Securities Exchange Act Release Nos. 57620 (April 4, 2008), 73 FR 19271 (April 9, 2008) (“QCT Exemptive Order”). See also Securities Exchange Act Release No. 54389 (August 31, 2006), 71 FR 52829 (September 7, 2006).

<sup>11</sup> 17 CFR 242.611(a).

<sup>12</sup> See Phlx Rule 1080, Commentary .08(a)(i) and Amendment No. 1.

<sup>13</sup> See Phlx Rule 1080, Commentary .08(a)(ix).

underlying security. Complex Orders with a conforming ratio will be accepted but Complex Orders with a nonconforming ratio will not.<sup>14</sup>

In addition, the proposal provides a DNA designation for Complex Orders.<sup>15</sup> A DNA Order is not COLA-eligible, as defined in Phlx Rule 1080, Commentary .08(d)((ii)(B), and will not trigger or join a Complex Order Live Auction (“COLA”).<sup>16</sup> DNA Orders are cancelled if not immediately executed.<sup>17</sup>

The proposal also updates the definitions of cPBBO and cNBBO to reflect the underlying security component of a stock-option order.<sup>18</sup> In addition, the proposal clarifies the definition of Complex Order Strategy and indicates that the Phlx’s system will assign a strategy identifier to each Complex Order Strategy.<sup>19</sup>

#### B. Priority

Currently, the priority provisions in Phlx Rule 1033(d) apply to Complex Orders trading on Phlx XL II and to complex orders trading on the Phlx’s floor.<sup>20</sup> The priority provisions in

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<sup>14</sup> See Notice at note 20.

<sup>15</sup> See Phlx Rule 1080, Commentary .08(a)(viii).

<sup>16</sup> Id.

<sup>17</sup> See Phlx Rule 1080, Commentary .08(a)(viii)(B). DNA Orders received prior to the opening or when the Complex Order Strategy is not available for trading will be cancelled. DNA Orders will initially be available only for Complex Orders with more than two options components or with an underlying security component. See Phlx Rule 1080, Commentary .08(a)(viii)(A) and (C).

<sup>18</sup> See Phlx Rule 1080, Commentary .08(a)(iv) and (vi). Specifically, the revised definitions indicate that when the underlying security is a component of a Complex Order, the best net debit or credit refers to the National Best Bid and/or Offer for the underlying security.

<sup>19</sup> See Phlx Rule 1080, Commentary .08(a)(ii).

<sup>20</sup> Phlx Rule 1033(d) states that when a member holding a hedge order, as defined in Rule 1066, and bidding or offering on the basis of a total credit or debit for the order has determined that the order may not be executed by a combination of transactions at or within the bids and offers established in the marketplace, then the order may be executed as a hedge order at the total credit or debit with one other member with priority over

Phlx Rule 1033(e) apply to orders trading on the Phlx's floor that include a stock and an option component.<sup>21</sup> The proposal adds new Phlx Rule 1080, Commentary .08(c)(iii) to provide priority provisions for Complex Orders, including Complex Orders with a stock or ETF component, trading on Phlx XL II.

Specifically, Phlx Rule 1080, Commentary .08(c)(iii)(A), which applies to Complex Orders composed solely of options, states that Complex Orders consisting of a conforming ratio<sup>22</sup> may be executed at a total credit or debit price with priority over individual bids or offers established in the marketplace (including customers) that are not better than the bids or offers comprising such total credit or debit, provided that at least one option leg is executed at a better price than the established bid or offer for that option contract and no option leg is executed at a price outside of the established bid or offer for that option contract. The Phlx states that new

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either the bid or the offer established in the marketplace that is not better than the bids or offers comprising such total credit or debit, provided that the member executes at least one option leg at a better price than established bid or offer for that option contract AND no option leg is executed at a price outside of the established bid or offer for that option contract. Hedge orders include spread, straddle, combination, and tied hedge orders. See Phlx Rule 1066(f).

<sup>21</sup> Phlx Rule 1033(e) states that when a member holding a synthetic option order, as defined in Rule 1066, and bidding or offering on the basis of a total credit or debit for the order has determined that the order may not be executed by a combination of transactions at or within the bids and offers established in the marketplace, then the order may be executed as a synthetic option order at the total credit or debit with one other member, provided that the member executes the option leg at a better price than the established bid or offer for that option contract, in accordance with Rule 1014. Synthetic option orders in open outcry, in which the option component is for a size of 100 contracts or more, have priority over bids (offers) of crowd participants who are bidding (offering) only for the option component of the synthetic option order, but not over bids (offers) of public customers on the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price.

<sup>22</sup> See Phlx Rule 1080, Commentary .08(a)(ix).

Phlx Rule 1080, Commentary .08(c)(iii)(A) provides the same priority as Phlx Rule 1033(d), under the same conditions, to a broader class of Complex Orders.<sup>23</sup>

Phlx Rule 1080, Commentary .08(c)(iii)(B) states that where a Complex Order consists of the underlying stock or ETF and one options leg in a conforming ratio,<sup>24</sup> such options leg does not have priority over bids and offers established in the marketplace, including customer orders. However, where a Complex Order consists of the underlying stock or ETF and more than one options leg in a conforming ratio, the options legs have priority over bids and offers established in the marketplace, including customer orders, if at least one options leg improves the existing market for that option.<sup>25</sup>

C. Execution of the Stock or ETF Component of a Complex Order

1. Role of NOS

To trade Complex Orders with a stock or ETF component through Phlx XL II, members of the Financial Industry Regulatory Authority, Inc. (“FINRA”) or the NASDAQ Stock Market (“Nasdaq”) must have a Uniform Service Bureau/Executing Broker Agreement (“AGU”) with NOS, and firms that are not members of FINRA or Nasdaq must have a Qualified Special Representative (“QSR”) arrangement with NOS.<sup>26</sup> NOS, a broker-dealer and FINRA member, serves as the Phlx’s Routing Facility and is subject to regulation as a facility of the Phlx.<sup>27</sup>

Phlx Rule 985(b), “Restrictions on Affiliation,” generally prohibits the Phlx or an entity with which it is affiliated from acquiring or maintaining an ownership interest in, or engaging in

<sup>23</sup> See Notice at notes 22 – 23 and accompanying text.

<sup>24</sup> See Phlx Rule 1080, Commentary .08(a)(ix) and note 13, supra.

<sup>25</sup> See Phlx Rule 1080, Commentary .08(c)(iii)(B).

<sup>26</sup> See Phlx Rule 1080, Commentary .08(a)(i).

<sup>27</sup> See Phlx Rule 1080(m)(iii).

a business venture with a Phlx member or an affiliate of a Phlx member in the absence of an effective filing with the Commission under Section 19(b) of the Act.<sup>28</sup> NOS is a member of Phlx and also an indirect wholly-owned subsidiary of Phlx's parent company, and therefore an affiliate of Phlx.<sup>29</sup> The Commission has approved NOS as an affiliate of Phlx for the purpose of routing orders in options listed and open for trading on Phlx XL II to away market centers pursuant to Phlx rules on behalf of Phlx.<sup>30</sup> Phlx Rule 1080(m)(iii) states that "[t]he sole use of the Routing Facility by the Phlx XL II system will be to route orders in options listed and open for trading on the Phlx XL II system to away markets pursuant to Exchange rules on behalf of the Exchange."

For NOS to perform additional functions for the Phlx, the Phlx must file a proposed rule change with the Commission pursuant to Section 19 of the Act and the rules and regulations thereunder.<sup>31</sup> In the current proposal, the Phlx proposes to allow NOS to act as the agent responsible for the execution of the stock or ETF component of a Complex Order in addition to its approved routing functions.<sup>32</sup> NOS's function with respect to the execution of the stock or ETF component of a Complex Order will be available to all Phlx member organizations.<sup>33</sup>

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<sup>28</sup> 15 U.S.C. 78s(b).

<sup>29</sup> See Securities Exchange Act Release No. 59995 (May 28, 2009), 74 FR 26750 (June 3, 2009) (order approving File No. SR-Phlx-2009-32) ("NOS Order").

<sup>30</sup> Id. The Commission also has approved NOS as an affiliate of Phlx for the limited purpose of providing routing services for Nasdaq Exchange for orders that first attempt to access liquidity on Nasdaq Exchange's systems before routing to Phlx, subject to certain conditions. See Securities Exchange Act Release No. 58179 (July 17, 2008), 73 FR 42874 (July 23, 2008) (order approving File No. SR-Phlx-2008-31).

<sup>31</sup> See NOS Order, supra note 29.

<sup>32</sup> Phlx Rule 1080(m)(iii)(A), as amended, states, in part, that "The sole use of the Routing Facility by the Phlx XL II system will be to route orders in options listed and open for trading on the Phlx XL II system to away markets pursuant to Exchange rules on behalf of the Exchange and, in addition, where one component of a Complex Order is the underlying security, to execute and report such component otherwise than on the

## 2. Execution of the Stock or ETF Component of a Complex Order

Where one component of a Complex Order is the underlying stock or ETF, the Phlx will electronically communicate the underlying security component to NOS for execution<sup>34</sup> after the Phlx's trading system determines that a Complex Order trade is possible and the prices for each of the components.<sup>35</sup> The execution and reporting of the underlying security component of the order will occur otherwise than on the Exchange, and NOS will handle these orders pursuant to applicable rules regarding equity trading,<sup>36</sup> including the rules governing trade reporting, trade-throughs, and short sales.<sup>37</sup>

NOS, a FINRA member, will be responsible for the proper execution, trade reporting, and submission to clearing of the underlying stock or ETF component of a Complex Trade.<sup>38</sup> The Phlx notes that NOS is subject to examination by FINRA and is responsible for compliance with applicable rules, including NASD Rule 3010, "Supervision," which generally requires NOS to establish and maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable NASD and FINRA rules.<sup>39</sup> The Phlx represents that NOS intends to have in place policies related to confidentiality

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Exchange, pursuant to Rule 1080.08(h)." See Amendment No. 2. See also Notice at note 31 and accompanying text.

<sup>33</sup> See Notice at 78324.

<sup>34</sup> See Phlx Rule 1080, Commentary .08(h).

<sup>35</sup> See Notice at 78324 and at note 44 and accompanying text.

<sup>36</sup> See Phlx Rule 1080, Commentary .08(h).

<sup>37</sup> See Notice at note 34 and accompanying text.

<sup>38</sup> See Notice at notes 31 – 32 and accompanying text.

<sup>39</sup> See Notice at note 32 and accompanying text.

and the potential for informational advantages relating to its affiliates, which are intended to protect against the misuse of material non-public information.<sup>40</sup>

For the reasons described below, the Phlx believes that the processing of the stock or ETF component of a Complex Order under the proposal will comply with applicable rules regarding equity trading, including the rules governing trade reporting, trade-throughs, and short sales.<sup>41</sup> The Phlx represents that NOS's responsibilities respecting these equity trading rules will be documented in NOS's written policies and procedures, and that NOS's compliance with these policies and procedures is monitored, reviewed, and updated as part of NOS's regular and routine regulatory program.<sup>42</sup>

### 3. Compliance with Trade Reporting Requirements and QCT Exemption

The Phlx states that NOS will report trades in the underlying stock or ETF to the FINRA/Nasdaq Trade Reporting Facility ("TRF").<sup>43</sup>

Phlx Rule 1080, Commentary .08(a)(i) permits a member to submit a Complex Order with a stock or ETF component only if the order complies with the QCT Exemption, and provides, further, that a member submitting a Complex Order with a stock or ETF component

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<sup>40</sup> See Notice at notes 32 – 33 and accompanying text. In addition, the Phlx notes that Phlx Rule 1080(m)(iii)(C) requires the Exchange to establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Phlx and NOS, and any other entity, including any affiliate of NOS. See Notice at note 33.

<sup>41</sup> See Notice at notes 42 – 43 and accompanying text.

<sup>42</sup> Id.

<sup>43</sup> See Notice at note 35 and accompanying text. The FINRA/Nasdaq TRF is a facility of FINRA that is operated by The NASDAQ OMX Group, Inc. ("Nasdaq OMX") and utilizes Automated Confirmation Transaction ("ACT") Service technology. See Notice at note 35.

represents that its order complies with the QCT Exemption.<sup>44</sup> In addition, as described in greater detail in the Notice, the Phlx represents that its trading system will validate compliance with each of the requirements of the QCT Exemption, thereby assisting NOS in carrying out its responsibilities as agent for these orders.<sup>45</sup>

#### 4. Compliance with Regulation SHO

The Phlx represents that the proposal raises no issues of compliance with the currently operative provisions of Regulation SHO.<sup>46</sup> The Phlx notes that when a Complex Order has a stock or ETF component, Regulation SHO requires a member organization to indicate whether that order involves a long or short sale. The Phlx states that its trading system will accept Complex Orders with a stock or ETF component marked to reflect either a long or short position and the trading system will reject orders not marked as either long or short.<sup>47</sup> In addition, the

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<sup>44</sup> See Phlx Rule 1080, Commentary .08(a)(i) and Amendment No. 1. The QCT Exemption applies to trade-throughs caused by the execution of an order involving one or more NMS stocks that are components of a “qualified contingent trade.” As described more fully in the QCT Exemptive Order, a qualified contingent trade is a transaction consisting of two or more component orders, executed as principal or agent, where: (1) at least one component order is an NMS stock; (2) all components are effected with a product or price contingency that either has been agreed to by the respective counterparties or arranged for by a broker-dealer as principal or agent; (3) the execution of one component is contingent upon the execution of all other components at or near the same time; (4) the specific relationship between the component orders (e.g., the spread between the prices of the component orders) is determined at the time the contingent order is placed; (5) the component orders bear a derivative relationship to one another, represent different classes of shares of the same issuer, or involve the securities of participants in mergers or with intentions to merge that have been announced or since cancelled; and (6) the Exempted NMS Stock Transaction is fully hedged (without regard to any prior existing position) as a result of the other components of the contingent trade. See QCT Exemptive Order, *supra* note 10.

<sup>45</sup> See Notice at notes 37 – 39 and accompanying text.

<sup>46</sup> 17 CFR 242.200 *et seq.* See Notice at note 40 and accompanying text.

<sup>47</sup> Telephone conversation between Andrea Orr, Special Counsel, Division of Trading and Markets, Commission, with Edith Hallahan, Associate General Counsel, Phlx, on January 25, 2011.

Phlx states that the trading system will reject orders not marked as buy, sell, or sell short.<sup>48</sup> The Phlx's trading system will electronically deliver the stock or ETF component to NOS for execution. Simultaneous with the options execution on the Phlx, NOS will execute and report the stock or ETF component, which will contain the long or short indication as it was delivered to the Phlx's trading system by the member organization.<sup>49</sup> The Phlx also states that various surveillance and examination regulatory programs check for compliance with Regulation SHO.<sup>50</sup>

The Phlx notes that the Commission amended Rules 201 and Rule 200(g) of Regulation SHO<sup>51</sup> earlier this year to adopt a short sale-related circuit breaker that, if triggered, would impose a restriction on the price at which securities may be sold short ("short sale price test restriction").<sup>52</sup> Under these amendments, a broker-dealer may mark certain qualifying short sale orders as "short exempt."<sup>53</sup> The Phlx notes that the Commission extended the compliance date for the amendments to Rules 201 and 200(g) until February 28, 2011.<sup>54</sup> The Phlx states that after the new provisions of Regulation SHO become operative, NOS will accept orders marked "short exempt."<sup>55</sup> The Exchange represents, further, that it intends to file a proposed rule change

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<sup>48</sup> See Notice at notes 40 – 42 and accompanying text.

<sup>49</sup> Id.

<sup>50</sup> Id.

<sup>51</sup> 17 CFR 242.201 and 200(g).

<sup>52</sup> See Securities Exchange Act Release No. 61595 (February 26, 2010), 75 FR 11232 (March 10, 2010)

<sup>53</sup> See Notice at note 41 and accompanying text.

<sup>54</sup> See Securities Exchange Act Release No. 63247 (November 4, 2010), 75 FR 68702 (November 9, 2010) (File No. S7-08-09) ("Compliance Date Extension Release").

<sup>55</sup> See Notice at note 42 and accompanying text.

addressing the new provisions.<sup>56</sup> In addition, the Phlx represents that NOS, as a trading center under Rule 201,<sup>57</sup> will be compliant with the requirements of Regulation SHO.<sup>58</sup>

5. Execution Price of the Underlying Security and Electronic Processing

Under the proposal, the execution price of the order for the underlying security must be within the security's high-low range for the day at the time the Complex Order is processed and within a specified price from the current market, which the Phlx will establish in an Options Trader Alert.<sup>59</sup> If the stock price is not within these parameters, the Complex Order is not executable.<sup>60</sup>

The Exchange believes that electronic submission of the stock or ETF component of a Complex Order should help ensure that the Complex Order, as a whole, is executed in a timely manner and at the desired price.<sup>61</sup> The Phlx notes that electronic communication eliminates the need for each party to separately manually submit the stock or ETF component to a broker-dealer for execution.<sup>62</sup> In addition, the Exchange emphasizes that the execution of the stock or ETF component of a Complex Order will be immediate, with the Phlx's system calculating the stock or ETF price based on the net debit/credit price of the Complex Order, while also calculating and determining the appropriate options price(s), all electronically and immediately.<sup>63</sup> The Exchange

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Id.

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17 CFR 242.201.

<sup>58</sup>

See Notice at notes 40 – 42 and accompanying text.

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See Phlx Rule 1080, Commentary .08(h).

<sup>60</sup>

Id.

<sup>61</sup>

See Notice at note 43 and accompanying text.

<sup>62</sup>

See Notice at notes 43 – 44 and accompanying text.

<sup>63</sup>

See Notice at note 44 and accompanying text.

believes that this approach will not require the Exchange to later nullify options trades if the stock price cannot be achieved.

The Exchange believes that it is appropriate for its affiliate, NOS, to act as the exclusive conduit for the execution of the stock or ETF component of a Complex Order.<sup>64</sup> The Phlx states that, as a practical matter, complex order programs on other exchanges necessarily involve specific arrangements with a broker-dealer to facilitate prompt execution.<sup>65</sup> The Phlx believes, further, that offering the benefits of prompt, seamless, automatic execution for both the options and stock or ETF components of a Complex Order is an important feature that should enhance the complex order processing available on options exchanges today.<sup>66</sup> The Phlx represents that neither the Exchange nor NOS intends to charge a fee for the execution of the stock or ETF component of a Complex Order.<sup>67</sup>

#### D. Complex Order Entry, Processing, and Execution

The Phlx proposes additional changes to Phlx Rule 1080, Commentary .08, relating to the entry, processing, and execution of Complex Orders. In this regard, the proposal revises Phlx

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<sup>64</sup> See Notice at note 46 an accompanying text. The Phlx also notes that Phlx Rule 985(c)(1) requires Nasdaq OMX, which owns NOS and the Exchange, to establish and maintain procedures and internal controls reasonably designed to ensure that NOS does not develop or implement changes to its system on the basis of non-public information regarding planned changes to the Exchange's systems, obtained as a result of its affiliation with the Exchange, until such information is available generally to similarly situated Exchange members and member organizations in connection with the provision of inbound routing to the Exchange. See Notice at note 46.

<sup>65</sup> See Notice notes 46 – 47 and accompanying text.

<sup>66</sup> Id.

<sup>67</sup> The Phlx notes, however, that TRF and clearing fees, not charged by Phlx or NOS, may result. The Phlx states that the National Securities Clearing Corporation (“NSCC”) and ACT will bill firms directly for their use of the NSCC and ACT systems, respectively. The Phlx represents that, to the extent that NOS is billed by NSCC or ACT, it will not pass through to firms such fees for the stock or ETF component of a Complex Order. See Notice at note 47.

Rule 1080, Commentary .08(c)(i) to indicate that a Complex Order with an underlying security component is eligible to trade only when the underlying security component is open for trading on its primary market.

In addition, the proposal revises Phlx Rule 1080, Commentary .08(e)(vi)(A)(1) to: (i) add the word “legging” to refer to the execution of a COLA-eligible order against interest in the leg market, as described in that paragraph; and (ii) indicate that legging may not occur when the underlying security is a component of a Complex Order. Similarly, the proposal revises Phlx Rule 1080, Commentary .08(f)(iii), relating to executions against the CBOOK, to indicate that legging will not take place when the underlying security is a component of a Complex Order.

Phlx Rule 1080, Commentary .08(e)(i)(B)(2) currently provides that a Complex Order received during the final ten seconds of a trading session is not COLA-eligible. The proposal modifies the rule to make this time configurable, but no longer than ten seconds.

The proposal also amends Phlx Rule 1080, Commentary .08(b)(ii) to allow Streaming Quote Traders (“SQTs”), Remote Streaming Quote Traders (“RSQTs”), non-SQT Registered Options Traders (“ROTs”), specialists, and non-Phlx market makers on another exchange to enter Complex Orders with more than two options components or an underlying security component as Day orders, in addition to entering them as Immediate or Cancel (“IOC”).<sup>68</sup> The Phlx believes that this change could encourage more orders from these market participants.

The proposal amends Phlx Rule 1080, Commentary .08(b)(iii) to indicate that Floor Brokers using the Options Floor Broker Management System (“FBMS”) may not enter DNA Orders, orders with a stock or ETF component, or orders with more than two legs. The Phlx

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<sup>68</sup> After the Phlx has fully rolled out its enhanced Complex Order system, Day orders also will become available for Complex Orders with two options components. See Phlx Rule 1080, Commentary .08(b)(ii).

notes that Floor Brokers are able to use systems other than FBMS to access Phlx XL II, and are unlikely to need or request changes to FBMS because they execute more complex orders in the trading crowd than through FBMS.<sup>69</sup>

The proposal also eliminates provisions that currently provide an SQT or RSQT quoting all of the components of a Complex Order in the leg market with priority over an SQT or RSQT quoting a single component of the order.<sup>70</sup> The Phlx believes that these changes will simplify the allocation process as the Exchange's system begins to accept more Complex Order types.<sup>71</sup> The Phlx believes, further, that the benefits provided by these provisions are not material, and that they are not being realized intentionally by market participants.<sup>72</sup> Under the revised rules, an SQT or RSQT quoting all components of a Complex Order will be on parity with SQTs and RSQTs quoting a single component.<sup>73</sup>

### III. Discussion and Commission Findings

The Commission finds that the proposed rule change, as amended, is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>74</sup> In particular, the Commission finds that the proposal is consistent with Section 6(b)(5) of the Act,<sup>75</sup> which requires, in part, that the rules of a national securities exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free

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<sup>69</sup> See Notice at 78323.

<sup>70</sup> See Phlx Rules 1080, Commentary .08(e)(vi)(A)(1), (f)(iii)(A), and (f)(iii)(B)(1).

<sup>71</sup> See Notice at note 29 and accompanying text.

<sup>72</sup> Id.

<sup>73</sup> Id.

<sup>74</sup> In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

and open market and a national market system, and, in general, to protect investors and the public interest. Currently, only Complex Orders with two options components may be traded on Phlx XL II. For the reasons discussed below, the Commission believes that the proposal, as amended, could facilitate the trading of Complex Orders by, among other things, permitting Complex Orders with up to six components, including the underlying stock or ETF, to be traded on Phlx XL II.

A. Priority Rules

As discussed above, the proposal adopts a new definition of Complex Order and adds a new defined term, conforming ratio, relating to Complex Orders. The Commission notes that the definition of a Complex Order in Phlx Rule 1080, Commentary .08(a)(i), including Complex Orders composed solely of options and Complex Orders composed of option(s) and the underlying stock or ETF, together with the definition of conforming ratio in Phlx Rule 1080, Commentary .08(a)(ix), are comparable to the definitions of Complex Order, Stock/Complex Order, and stock-option order adopted by other options exchanges.<sup>76</sup>

A Complex Order with a nonconforming ratio will not be accepted,<sup>77</sup> and only Complex Orders with conforming ratios will be eligible for the priority treatment provided in Phlx Rule 1080, Commentary .08(c)(iii).<sup>78</sup> Specifically, for Complex Orders composed solely of options,

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<sup>75</sup> 15 U.S.C. 78f(b)(5).

<sup>76</sup> See, e.g., ISE Rule 722(a)(1) and NYSEAmex Rule 900.3NY(e) (defining a complex order). See also NYSEAmex Rule 900.3NY(h)(2) (defining a Stock/Complex Order) and ISE Rule 722(a)(2) and NYSEAmex Rule 900.3NY(h)(1) (defining a stock-option order).

<sup>77</sup> See Notice at note 20.

<sup>78</sup> Throughout Phlx Rule 1080, Commentary .08, the proposal replaces references to the priority provisions in Phlx Rule 1033(d) with references to the priority provisions in Phlx Rule 1080, Commentary .08(c)(iii). Phlx Rule 1033(d) will continue to apply to trading on the Phlx's floor, and the priority provisions in Commentary .08(c)(iii) will apply to Complex Orders trading on PHLX XL II.

Phlx Rule 1080, Commentary .08(c)(iii)(A) provides that a Complex Order with a conforming ratio may be executed at a total net credit or debit with priority over individual bids or offers established in the marketplace (including customers) that are not better than the bids or offers comprising such total credit or debit, provided that at least one option leg is executed at a better price than the established bid or offer for that option and no option leg is executed at a price outside of the established bid or offer for that option. The priority provisions in Phlx Rule 1080, Commentary .08(c)(iii)(A) are consistent with the existing priority provisions in Phlx Rule 1033(d), which will continue to apply to trading on the Phlx's floor, and with the priority rules of other options exchanges.<sup>79</sup>

For Complex Orders composed of the underlying stock or ETF and one options leg in a conforming ratio, Phlx Rule 1080, Commentary .08(c)(iii)(B) provides that the options leg does not have priority over bids and offers established in the marketplace, including customer orders. This provision is similar to Phlx Rule 1033(e),<sup>80</sup> and to the requirements of other options exchanges.<sup>81</sup> For a Complex Order composed of the underlying stock or ETF and more than one

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<sup>79</sup> See, e.g., ISE Rule 722(b)(2) and NYSEAmex Rule 980, Commentary .02. See also CBOE Rules 6.45(e), 6.45A(b)(ii), and 6.45B(b)(ii). The Phlx states that Phlx Rule 1080, Commentary .08(c)(iii) provides the same priority as Phlx Rule 1033(d), under the same conditions, to a broader class of Complex Orders. See Notice at notes 22 – 23 and accompanying text.

<sup>80</sup> Phlx Rule 1033(e) requires the option leg of a stock-option order (called a synthetic option order) to be executed at a price better than the established bid or offer for that option. For synthetic option orders trading in open outcry in which the option component is for 100 contracts or more, the synthetic option order has priority over crowd participants who are bidding (offering) only for the option component of the order, but over the bids (offers) of public customers in the limit order book, and not over crowd participants that are willing to participate in the synthetic option order at the net debit or credit price.

<sup>81</sup> See, e.g., CBOE Rule 6.53C, Commentary .06(b) and NYSEAmex Rule 980NY, Commentary .03(b) (the option leg of a Stock-Option Order will not be executed on the exchange's system at the exchange's best bid (offer) in that series if one or more public customer orders are resting at that price on the electronic book, unless the option leg

options leg in a conforming ratio, the options legs have priority over bids and offers established in the marketplace, including customer orders, if at least one options leg improves the existing market for that option.<sup>82</sup> This provision is similar to ISE Rule 722(b).<sup>83</sup>

B. Execution of the Stock or ETF Component of a Complex Order

1. NOS's Role as Agent for the Stock or ETF Component of a Complex Order

NOS serves as the Phlx's Routing Facility. In addition to its currently approved routing functions, the Phlx proposes to allow NOS to act as the agent for orders to buy and sell the underlying stock or ETF component of a Complex Order.

As described more fully above, after the Phlx's system determines that a Complex Order trade is possible and the prices for the trade, the Phlx will electronically communicate the stock or ETF component of the Complex Order to NOS for execution. NOS, acting as agent for the orders to buy and sell the underlying stock or ETF, will execute the orders in the over-the-counter ("OTC") market and will handle the orders pursuant to applicable rules regarding equity trading,<sup>84</sup> including the rules governing trade reporting, trade-throughs, and short sales.<sup>85</sup> NOS

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trades with such public customer order(s)); and ISE Rule 722(b)(2) (a stock-option order with one options leg has priority over bids and offers established in the marketplace by Professional Orders and market makers at the price of the options leg, but not over such bids or offers established by Priority Customer Orders). See also CBOE Rule 6.45(e) (stock-option orders have priority over bids (offers) of the trading crowd but not over bids (offers) in the public customer limit order book).

<sup>82</sup> See Phlx Rule 1080, Commentary .08(c)(iii)(B).

<sup>83</sup> ISE Rule 722(b)(2) provides, in part, that the options legs of a stock-option order with more than one options leg may be executed at a total net credit or debit with one other Member without giving priority to established bids or offers that are no better than the bids or offers comprising the net credit or debit, provided that if any of the established bids or offers consist of a Priority Customer Order, the price of at least one leg must trade at a price that is better than the corresponding bid or offer in the marketplace by at least one minimum trading increment.

<sup>84</sup> See Phlx Rule 1080, Commentary .08(h).

will be responsible for the proper execution, trade reporting, and submission to clearing of the underlying stock or ETF component of a Complex Order.<sup>86</sup>

Based in part on the Phlx's statements and representations in the Notice, the Commission believes that the proposal to allow NOS to serve as the agent responsible for executing the stock or ETF component of a Complex Order is consistent with the Act. The Commission notes that, as a facility of the Phlx, NOS is subject to oversight by the Commission and by the Phlx.<sup>87</sup> In addition, NOS, a member of FINRA, is responsible for compliance with applicable rules regarding equity trading, including rules governing trade reporting, trade-throughs and short sales, and is subject to examination by FINRA.<sup>88</sup> Because NOS will execute the stock or ETF component of a Complex Order in the OTC market, the principal regulator of these trades will be FINRA, rather than the Phlx or Nasdaq.<sup>89</sup>

The Phlx notes that NASD Rule 3010 generally requires NOS to establish and maintain supervisory systems that are reasonably designed to achieve compliance with applicable securities laws and regulations and applicable NASD and FINRA rules.<sup>90</sup> The Phlx represents that NOS intends to have in place policies related to confidentiality and the potential for

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<sup>85</sup> See Notice at note 34 and accompanying text.

<sup>86</sup> See Notice at notes 31 – 32 and accompanying text.

<sup>87</sup> Phlx Rule 1080(m)(iii)(A) states that NOS is subject to regulation as a facility of the Phlx. Phlx Rule 1080(m)(iii)(D) provides, further, that the books, records, premises, officers, directors, agents, and employees of NOS, as a facility of the Phlx, shall be deemed to be the books, records, premises, officers, directors, agents, and employees of the Phlx for purposes of and subject to oversight pursuant to the Act. The books and records of NOS, as a facility of the Phlx, shall be subject at all times to inspection and copying by the Phlx and the Commission.

<sup>88</sup> See Notice at 78324. Phlx Rule 1080(m)(iii)(A) states that NOS is a member of an unaffiliated self-regulatory organization which the designated examining authority for NOS.

<sup>89</sup> See Notice at 78324.

informational advantages relating to its affiliates, which are intended to protect against the misuse of material non-public information.<sup>91</sup> The Phlx represents, further, that NOS's responsibilities respecting applicable equity trading rules, including the rules governing trade reporting, trade-throughs, and short sales, will be documented in NOS's written policies and procedures, and that NOS's compliance with these policies and procedures is monitored, reviewed, and updated as part of NOS's regular and routine regulatory program.<sup>92</sup>

The Phlx represents that neither the Exchange nor NOS intends to charge a fee for the execution of the stock or ETF component of a Complex Order.<sup>93</sup> The Commission notes that if the Phlx or NOS decides in the future to charge fees for NOS's execution of the stock or ETF component of a Complex Order, or to modify its rules relating to NOS's execution of the stock or ETF component of a Complex Order, the Phlx would be responsible for filing the proposed fee or rule change with the Commission pursuant to Section 19(b) of the Act.<sup>94</sup> The Commission notes, in addition, that NOS's execution of the stock or ETF component of a Complex Order is subject to exchange non-discrimination requirements.<sup>95</sup>

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<sup>90</sup> See Notice at note 32 and accompanying text.

<sup>91</sup> See Notice at note 33 and accompanying text. In addition, the Phlx notes that Phlx Rule 1080(m)(iii)(C) requires the Exchange to establish and maintain procedures and internal controls reasonably designed to adequately restrict the flow of confidential and proprietary information between the Phlx and NOS, and any other entity, including any affiliate of NOS. See Notice at note 33.

<sup>92</sup> See Notice at 78325.

<sup>93</sup> See Notice at note 47 and accompanying text. The Phlx notes, however, that TRF and clearing fees, not charged by Phlx or NOS, may result. The Phlx states that NSCC and ACT will bill firms directly for their use of NSCC and ACT systems, respectively. Further, the Phlx represents that, to the extent that NOS is billed by NSCC or Act, it will not pass through such fees to firms for the stock or ETF portion of a Complex Trade under this proposal. See Notice at note 47.

<sup>94</sup> See NOS Order, supra note 30, at footnote 84.

<sup>95</sup> Id.

C. DNA Designation and Additional Definitions

The proposal adopts a DNA designation for Complex Orders.<sup>96</sup> A DNA Order is not COLA-eligible and will not trigger or join a COLA.<sup>97</sup> The Commission believes that DNA Orders will provide additional flexibility in executing Complex Orders by allowing market participants to submit Complex Orders that will not trigger or join a COLA.

The Commission believes that the revised definitions of cPPBO and cNBBO will update those definitions to reflect that the underlying security could be component of a Complex Order.<sup>98</sup> The Commission believes that the changes to the definition of Complex Order Strategy<sup>99</sup> will help to clarify that term and the role of the Phlx's system in assigning a strategy identifier to a Complex Order Strategy.

D. Complex Order Entry, Processing, and Execution

The Commission finds that the changes to Phlx Rule 1080, Commentary .08(c)(i) indicating that a Complex Order with an underlying security component is eligible to trade only when the underlying security is open for trading on its primary market, and the changes to Phlx Rule 1080, Commentary .08(e)(vi)(A)(1) and .08(f)(iii) that indicate that legging may not occur, either in a COLA or against the CBOOK, when the underlying security is a component of a Complex Order, should help to clarify the operation of the Phlx's rules relating to the execution of Complex Orders with an underlying stock or ETF component. Similarly, the Commission believes that adding the term "legging" to Phlx Rule 1080, Commentary .08(e)(vi)(A)(1) to refer to the activity described in that rule could help to clarify the rule.

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<sup>96</sup> See Phlx Rule 1080, Commentary .08(a)(viii).

<sup>97</sup> Id.

<sup>98</sup> See Phlx Rule 1080, Commentary .08(a)(iv) and (vi).

<sup>99</sup> See Phlx Rule 1080, Commentary .08(a)(ii).

The amendment to Phlx Rule 1080, Commentary .08(e)(i)(B)(2) that permits the Phlx to determine the time period, which will not exceed ten seconds, at the end of a trading session when an order will not be COLA-eligible should provide the Phlx with flexibility in determining the time period within which the Exchange will not initiate a COLA during the final seconds of a trading session. The Commission notes that the Phlx will establish this time period in an Options Trader Alert.<sup>100</sup>

The Commission believes that modifying Phlx Rule 1080, Commentary .08(b)(ii) to allow SQTs, RSQTs, non-SQT ROTs, specialists, and non-Phlx market makers on another exchange to enter Complex Orders with more than two options components or an underlying security component as Day orders, in addition to entering them as IOC orders, could encourage these market participants to submit Complex Orders by providing them with greater flexibility in entering orders.

The Commission believes that the amendments to Phlx Rule 1080, Commentary .08(b)(iii) indicating that Floor Brokers using the FBMS may not enter DNA Orders, orders with a stock or ETF component, or orders with more than two legs are reasonable because, according to the Phlx, Floor Brokers are able to use systems other than FBMS to access Phlx XL II.<sup>101</sup> In addition, the Commission notes that the Phlx believes that Floor Brokers are unlikely to need or request changes to FBMS because they execute more complex orders in the trading crowd than through FBMS.<sup>102</sup>

The Commission believes that the changes to Phlx Rules 1080, Commentary .08(e)(vi)(A)(1), (f)(iii)(A), and (f)(iii)(B)(1) that place an SQT or RSQT quoting all components

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<sup>100</sup> See Phlx Rule 1080, Commentary .08(e)(B)(2).

<sup>101</sup> See Notice at 78323.

<sup>102</sup> Id.

of a Complex Order on parity with SQTs and RSQTs quoting a single component are consistent with the Act. The Phlx believes that these changes will simplify the allocation process as PHLX XL II begins to accept more Complex Order types.<sup>103</sup> In addition, the Phlx believes that the benefits provided by the current rules giving priority to SQTs and RSQTs quoting all components of a Complex Order are not material, and that they are not being realized intentionally by market participants.<sup>104</sup> The Commission notes that under the revised rules, public customer orders will continue to have priority over SQTs and RSQTs.<sup>105</sup>

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<sup>103</sup> See Notice at note 29 and accompanying text.

<sup>104</sup> Id.

<sup>105</sup> See Phlx Rules 1014(g)(vii) and 1080, Commentary .08(e)(vi)(A)(1), (f)(iii)(A), and (f)(iii)(B)(1).

IV. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>106</sup> that the proposed rule change (File No. SR-Phlx-2010-157), as amended, is approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>107</sup>

Elizabeth M. Murphy  
Secretary

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<sup>106</sup> 15 U.S.C. 78s(b)(2).

<sup>107</sup> 17 CFR 200.30-3(a)(12).